CIBC PRIVATE WEALTH

THE STAN CLARK FINANCIAL TEAM'S

PERSPECTIVES

IN THIS ISSUE:

Volume 15 – Issue 3 April 2024

STAN CLARK
Senior Wealth Advisor

Even experts make inconsistent judgments. All the information they have can cloud their reasoning! As I discuss in this issue's behavioral finance article, *algorithms*, or step-by-step instructions for calculating a result, have proven far more reliable. In our *Quarterly Economic Report*, Michael Chu and I review the economy's continuing good performance – as well as the factors that could influence whether this continues. And, looking at the hazards that prevent stock market success, Tom Cowans provides safety tips to avoid those hazards.

Stan

Stan Clark is a Portfolio Manager and Senior Wealth Advisor for The Stan Clark Financial Team at CIBC Wood Gundy. Stan has direct responsibility for the team and oversees all areas of financial planning, investment selection and investment management.

Behavioral Finance

WHAT BEHAVIORAL FINANCE TELLS US ABOUT MAKING JUDGMENTS – EVEN EXPERT ONES

By Stan Clark, Senior Wealth Advisor

One of the clear lessons from behavioral finance is that human judgment lacks consistency. Our judgment simply isn't a reliable tool for situations such as: predicting freshman performance at university; choosing the best job candidate through interviews; or, indeed, forecasting stock prices.

In this article, I'd like to discuss more of what behavioral finance tells us about making judgments, even expert ones.

According to Dr. Daniel Kahneman, Nobel laureate and author of *Thinking Fast and Slow*, human judgment almost always fails to exceed – and most often underperforms – the results of simple mathematical algorithms.

An *algorithm* is a set of step-by-step instructions for calculating a result. To provide accurate predictions, often all you need is an algorithm that takes into account only a few variables.

Kahneman gives the example of predicting the prices of certain Bordeaux wines. Red wines generally improve with age, to a point. Predicting how good a wine will be, and then how high a price it can command, is important for both vintners and for people who invest in or collect wines.

Traditionally, those predictions have been made by wine experts who combine their tastings of particular young vintages with their knowledge of grape-growing conditions and current prices.

Trouble is, their predictions aren't particularly reliable. Not because such experts don't know their wines. Rather, because they know so very much that it interferes with their accuracy.

Kahneman cites the example of economist Orley Ashenfelter, who wanted to simplify wine-price predictions. Ashenfelter created an algorithm using only three variables: average temperature over the summer growing season; amount of rain at harvest time; and total rainfall during the previous winter. Ashenfelter's algorithm provides highly accurate predictions about prices, even for 20 or more years into the future. The correlation between the algorithm's predictions and actual prices is 0.90 (where 1.00 would be a perfect correlation).

However, as Ashenfelter and others discovered, attempting to replace expert judgments with mathematical algorithms encounters significant resistance.

In the investing community, people eagerly seek expert opinions on which stocks to buy and sell, and where the market is going, especially over the short term. This happens despite the fact that, over the short term, stock fluctuations are not predictable. Even stranger, millions of trades occur every day, based on differing opinions as to whether a company's stock is currently overvalued or underpriced. Yet those differing expert opinions are presumably based on the same information about the company, such as its price-earnings (P/E) ratios, trading volumes, price history and management strengths and weaknesses.

A number of studies provide evidence that the predictions and performance of expert investors, such as fund managers, correlate poorly with actual stock prices. When these experts are asked to repeat their judgments using the same information, they often contradict their earlier judgments.

Then why do experts, and those who seek them out, cling to the notion that expert opinions are accurate?

As Kahneman explains, it is partly a distaste for replacing human activity with machines and arithmetic. It's also partly what he calls the *illusion of validity*.

Experts, after all, work hard to attain their expertise. In *Outliers*, Malcolm Gladwell reports that it takes around 10,000 hours of study and practice to gain the experience needed to be an expert in almost any field. It's not surprising that experts resist accepting judgments from a computer-run algorithm.

But perhaps, in the end, the real expert is the one who objectively determines what type of data to compute – and who can set aside biases and preconceptions when interpreting the results.

TEAM TALK

Meghan Jones
Client Associate

Nacho

What have you been up to lately?

My husband and I adopted a sweet rescue pup from Acre Dogs in Cabo, Mexico last April. Meet Nacho! He is a very good boy; loves to play fetch with his ball (and most recently, a frisbee!), is a foodie like his parents and prefers to sleep under the covers. Nacho has been a wonderful addition to our family and we often pinch ourselves on how lucky we are!

Any travel plans this year?

Yes! We recently came back from a week in Palm Desert, where we road tripped to Disneyland for a day! We've also booked a trip to Japan this coming fall. We will be there for 2.5 weeks, travelling to Tokyo, Hiroshima, Osaka and Kyoto. My husband, Adam, is most looking forward to the food! I'm excited to experience the culture and work on my photography. I recently inherited a film camera from my grandparents and can't wait to start documenting!

Quarterly Economic Update:

BULL MARKET CONTINUES, BUT BE AWARE OF WARNING SIGNS

By Stan Clark, Senior Wealth Advisor and Michael Chu, Senior Wealth Advisor

The first quarter of 2024 saw a continuation of many 2023 themes. In the U.S., inflation and interest rates continued to weigh on the economy and stock markets, but not enough to tip the markets into a recession. Inflation kept to its slow and bumpy descent, but questions remain about the stickiness of the "last mile." Labour markets remained historically strong and economic growth continued near long-term trends.

The narrative has changed from "When will they stop hiking rates?" to "When will they start cutting?" Despite higher interest rates, the stock market enjoyed gains fuelled by: enthusiasm about the mere prospects for rate cuts without being accompanied with a recession; strong corporate earnings; and the potential transformational impact of artificial intelligence (AI). At home, the TSX was up 6.6% in the first quarter of 2024. The World Equity Index, a gauge of stocks around the world, was up 11.3% (in C$)

	1st Quarter 2024	Trailing P/E	Trailing Eanings Yield	Dividend Yield
Canada	6.6%	16.4	6.1%	3.1%
U.S.	13.0%	26.2	3.8%	1.4%
Europe	9.1%	15.1	6.6%	3.1%
Japan	15.8%	16.9	5.9%	1.9%
EAFE (Europe, Australasia, Far East)	8.2%	15.7	6.4%	2.9%
Emerging Markets	4.7%	15.6	6.4%	2.8%
World	11.3%	22.0	4.6%	1.8%

Source: Bloomberg

Valuations

The forward (expected) price-to-earnings (P/E) ratio in the U.S. is 21 times earnings, which is about 20% more expensive than at the start of the bull market in 2022. The current valuation is higher than average, but to give us some perspective, during the dotcom bubble it was 25 times, or about 20% more expensive, than today. Unlike that era, today's tech firms are generating profit and growth that, while not keeping pace with price action, is on a similar trajectory. Overall, corporate after-tax profits are a record \$2.8 trillion. Corporations paid a near record \$1.9 trillion in dividends. Undistributed profits combined with tax reported depreciation generated a record \$3.5 trillion in corporate cash flow.

The graph below shows the forward P/E ratios for the S&P 500 and technology companies since 1995. As you can see, valuations are high and arguably bubbly, but it's not a worst-case scenario – meaning there's room for valuations to grow before heading into real bubble territory.

Valuations in Canada and other parts of the world are much cheaper than in the U.S. As you can see in the table, stocks in Canada are 40% cheaper than in the U.S. on a trailing P/E ratio. This is consistent when looking at dividends as a measurement of value: Canadian stocks yield twice as much (i.e., are half as expensive) compared to U.S. stocks!

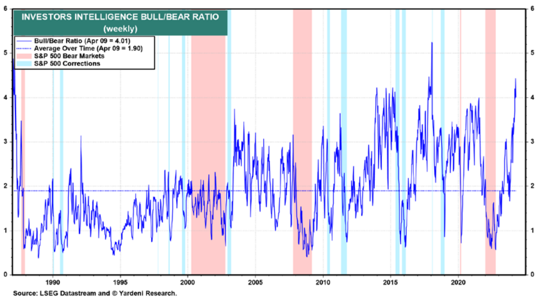
Everyone is bullish

The Investors Intelligence Bull/Bear Ratio (BBR) is a contrarian indicator, meaning you should do the opposite of what the crowd is thinking. Historically, it's paid off to be bullish if the BBR is extremely bearish and vice versa. In October 2022, the BBR was 0.57, the lowest since the Great Financial Crisis of 2008. The bear market bottomed soon after. The S&P 500 is up about 50% so far from that point.

So, naturally, almost everyone is bullish. Today, there are about four times as many bulls as bears. This is a concern – but it's also important to know that BBRs below a 1.0 reading work better than readings above 3.0 work as sell signals. But if bulls are fully invested, there may not be enough bears flipping over to the bull side to keep the momentum of the bull market going.

Don’t mess with success

The Fed has made clear that it is “not far” from getting enough confidence to start lowering rates. “…if the economy evolves broadly as expected, it will likely be appropriate to begin dialing back policy restraint at some point this year.”



Fed Chair Powell has acknowledged that the economy is performing well, while the labour market remains tight. In addition, inflation has moderated significantly since last summer. This raises an important question. If the economy is doing well with the current level of interest rates, why lower them?

Powell and his colleagues seem to share the view that if inflation continues to moderate, they will have to lower the federal funds rate so it doesn’t become too restrictive and cause a recession. If inflation falls to 2% per cent and the federal funds rate remains at 5.25%, the real rate would be 3.25%. History suggests that several previous recessions happened after the real federal funds rate rose above 3%.

However, according to top economist Ed Yardeni, history shows that recessions aren’t caused by excessively high real interest rates. As the economy grows it builds up confidence, leading to inflationary excesses in goods and services as well as in asset prices. The buildup of such inflationary and speculative excesses forces the Fed to raise interest rates. Typically, short-term rates rise faster than long-term rates, resulting in an inversion of the yield curve. This signals investors’ expectation that, if short-term rates continue to be hiked, something will break in the financial system – which is often correct. In the past, financial crises quickly turned into credit crunches where even good credit borrowers could not borrow, potentially stalling the economy. The Fed responded by lowering rates and “un-inverting” the yield curve.

Most recessions we’ve experienced since the 1960s have been caused by the tightening of monetary policy until this triggered a financial crisis. A credit crunch quickly followed, which then caused a recession. Past financial crises have caused the Fed to lower interest rates, not a perception that the rate was too high and about to cause a recession. So, inverted yield curves don’t cause recessions, but they can anticipate recessions, and often correctly – just not in the past couple of years.

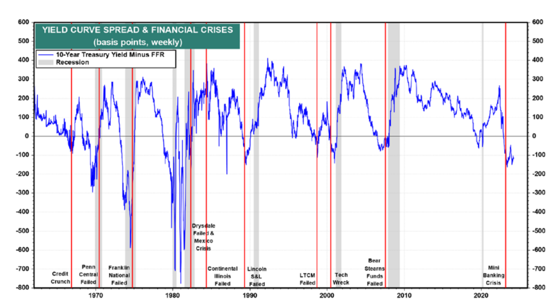
Indeed, the past two years have been exceptional. Inflation soared during 2022 and 2023, then moderated in 2024. Interest rates were hiked to lower inflation, which did happen, and so far without causing a recession. What’s changed?

During the 2008 crisis, the Fed learned how to rapidly establish emergency liquidity facilities. That’s what it did in response to the pandemic lockdowns; as a result, the Covid recession lasted only two months. The Fed did the same thing again last year, when a banking crisis developed during March with the failure of Silicon Valley Bank. No recession resulted. This is known as the *Fed Put* – the belief that the Fed will step in to limit a stock market decline.

If the Fed can continue to manage financial crises and avert economy-wide credit crunches, it will reduce the risk of a recession during monetary tightening cycles. That’s one of the main reasons the economy continued to grow over the past two years in the face of a significant tightening of monetary policy.

Things can still go wrong, though. Besides a credit crunch, an energy shock could cause a recession. An *energy shock* is a surge in oil prices, causing massive inflation and forcing the central banks to raise interest rates. The ongoing conflict in Ukraine, and now potentially in the Middle East, could lead to a surge in oil prices reminiscent of the crises experienced in the 1970s.

If financial crises are the main risk for recessions, the Fed might want to focus more on credit/liquidity in deciding rate levels. Why lower rates and risk inflating a speculative bubble in asset prices like stocks that are already soaring to record highs?



Why mess with success?

Rational or irrational exuberance?

The financial markets are showing signs of exuberance. The question is which variety of exuberance it is: rational or irrational. Looking back to December 5, 1996, then-Fed Chair Alan Greenspan famously asked, “But how do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions?”

Yardeni’s theory is that recessions are caused by credit crunches triggered by financial crises attributable to the tightening of monetary policy. But Fed officials seem to believe that higher real interest rates can cause recessions, too. They’ve been signalling their intention to lower the federal funds rate three times over the rest of this year if inflation continues to moderate. This may reduce the risk of a recession, but it could also easily cause investors to become even more exuberant. Irrationally exuberant, that is, leading to the “unduly escalated asset values, which then become subject to unexpected and prolonged contractions” that Greenspan warned about.

Still inverted

Another of our favourite economists, Ed Hyman, founder of Evercore ISI (and ranked #1 economist 43 times in a row in the Institutional Investor survey), isn’t as optimistic that the U.S. can avoid a recession. Hyman thinks the current financial conditions are still tight due to the Fed’s quantitative tightening, that is, selling bonds to reduce the size of its balance sheet. The yield curve has been inverted since late 2022. The last recession occurred 18 months after the inversion. Based on this, we might have around another six months before a recession.

Hyman acknowledges that the economy is doing well and inflation is coming down, so it might be hard to tell if or when the recession happens. He further acknowledges that the odds of a soft landing are higher because inflation has been weaker.

Also, Hyman points out that monetary policy is difficult, comparable to turning an oil tanker. What you do today might take a year and a half to take full effect. The last rate hike in the U.S. was July 2023 – which could mean we might not see the results until 2025.

Presidential cycle

According to the *presidential cycle theory*, since 1929 the third and fourth years of a U.S. president’s term should have above-average returns. The narrative behind this is: "Presidents do the heavy lifting in their first and second year in office and then pivot to preparing for re-election in the fourth year by being friendly to markets in the third year." This theory bodes well for 2024, the fourth year of the current cycle. It's noteworthy that, to date this year, the S&P 500 has already surpassed the average return for year four.

As discussed, many are expecting rate cuts late this year or early next year. The Fed is supposed to act independently of politics. So, there may be some pressure to defer cuts until after the November presidential election. There is a Fed meeting just after the election and then another in December, meaning the Fed has plenty of opportunity to cut if cuts are justified.

Not tamed yet

A third straight hotter-than-expected key inflation report is spurring concerns that inflation is becoming entrenched and likely delaying interest rate cuts. The core consumer price index, which excludes food and energy, recently reported an annual rate of 3.8%, defying expectations for a downtick. Again, prices of goods continued their downward trend while prices of services accelerated.

Higher inflation, combined with stronger-than-expected labour and economic activity, further reduces the need to start reducing rates soon. With the economy doing well, the Fed can afford to be patient and more assured. There should be no rush to lower rates.

Looking ahead

The current bull market is a sign of confidence in the durability of the global economy and robustness of corporate earnings. It's also a sign that central bank actions are having their intended effect. So far investors seem unfazed as stock prices march higher, despite a pullback in expectations of interest rate cuts. Stock prices have been backed by earnings growth, but this will need to persist to justify valuations.

Risks are always present. But rather than overreact to uncertain predictions, it's best to have a disciplined process combined with a resilient financial plan. This will help us navigate an unpredictable future.

Stan Clark is a Portfolio Manager and Senior Wealth Advisor for The Stan Clark Financial Team at CIBC Wood Gundy. Stan has direct responsibility for the team and oversees all areas of financial planning, investment selection and investment management.

Michael Chu is a Portfolio Manager and Senior Wealth Advisor for The Stan Clark Financial Team at CIBC Wood Gundy. Michael is a specialist in investment research and information technology.

Financial Planning

STOCKS VS. BONDS: WHY SOME PEOPLE LOSE AT A WINNERS' GAME

By Tom Cowans, Wealth Advisor

As we noted in the March issue, in the long run stocks provide the best returns of any major asset class. However, we all hear stories of people who've done poorly with stocks. What's up with that?

Like many things in life, tools that can be helpful can also be harmful if not used properly. Think about driving a car. Or using electricity. Or even taking a bath! For most things in life, you need to have some basic safety rules.

For the stock market, we've found three main hazards that prevent people from succeeding with their investments. These hazards are:

- Lack of diversification
- Investing in speculative stocks
- Market timing.

Diversification (in finance, often called "the only free lunch") is key to being a smart investor and succeeding in the stock market over the long term. Diversification means investing in different companies, industries, sectors and countries. Investing in only one sector, or using only one method of selection, increases your risk. By diversifying you wisely spread your money across several different areas.

You also create a cushion. For example, if one industry experiences a hardship and drops, your money in other areas will likely not have the same consequences. That money may actually benefit! Take energy as an example. If energy prices fall, energy companies will suffer. But companies that use a lot of energy should benefit. So, investing in both types will help reduce the risk from uncertain energy prices.

The second factor to consider is the type of stocks. Looking at stocks being hyped in the news, and then rushing to put money into them, is *speculative* investing – and risky. Sure, hearing about new start-up companies is intriguing. However, with no track record of their ability to grow or sustain profitability, such stocks may not be the best place for you to invest your hard-earned funds.

Fact is, the failure rate of start-ups is high. It usually makes more sense to invest in well-established companies that made it through the start-up phase and now have organizations, processes and tested, proven strategies. In the long run, proven success will always be a safer choice than hopeful speculation.

Trying to "time the market" is the third reason investors tend not to do well with stocks. Often people get emotionally involved in their investments. Trying to predict ups and downs, they keep moving their money in and out of the market. Such *market timing* is tempting, but studies show that predicting market fluctuations is nearly impossible. Trying to do so actually increases your risk of doing poorly over time.

By letting their emotions take control, then buying high and selling low, these investors underperform the very market they are trying to follow. *Time in the market*, not timing the market, is the key. Only by staying invested for long periods can you increase your chances of success. Famed investor Charlie Munger put it well: "The first rule of compounding: Never interrupt it unnecessarily."

Invest for the long term

To be truly successful, view the money you put into the stock market as a long-term investment. One way to do this effectively is by trying your best to remove your emotions from the equation. And part of that means not checking your investment account daily!

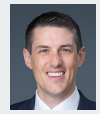
To help you succeed with your investments in stocks, you need to flip the above hazards around and turn them into safety tips for investing:

1. Diversify your portfolio

2. Invest in well-established companies, and
3. Avoid trying to time the markets.

Following the market in the short term can be nerve-wracking. For that reason, only invest in stocks with money you won't be needing soon. Knowing that your stock market money isn't needed in the short term will help you ignore the market's short-term swings.

And, somewhat counterintuitively, if you have savings or surplus cash put aside for your short-term needs, you should view any stock market drops as good events. When these drops occur, they enable you to add to your long-term investments at discounted prices. Of course this only works if you add when markets drop, rather than doing the opposite.



Tom Cowans is a Portfolio Manager and Wealth Advisor for the Stan Clark Financial Team at CIBC Wood Gundy.

SCFT Trivia

Play our trivia – support the cure!

For every correct entry we receive in our trivia contest, the Stan Clark Financial Team will contribute $1 to CIBC's "Run for the Cure" to raise money for breast cancer research. Each correct entry will also be entered into the draw for this month's prize. Email or phone in your entry today.

Answer all four questions to be entered into the draw for this month's prize. *Hint: You can find the answers inside this newsletter.*

1. According to Dr. Daniel Kahneman, Nobel laureate and author of Thinking Fast and Slow, human judgment:
   a) Is trustworthy only if experts are making the judgment
   b) Almost always fails to exceed – and most often underperforms – the results of simple mathematical algorithms
   c) Succeeds as long as the human has lots of personal experience to base the judgment on
   d) Works if the human making the judgment is lucky, so why not try your luck at it?

2. According to the presidential cycle theory, since 1929 the third and fourth years of a U.S. president's term have this result on the stock market:
   a) The market plummets, as investors are unsure who the next president will be and what that person will do
   b) No result at all, as investors don't care what part of the presidential cycle they're in
   c) The market experiences wild fluctuations, reflecting investors' changing optimism and pessimism about the upcoming election
   d) Investors enjoy above-average returns, because presidents prepare for re-election in the fourth year by being friendly to markets in the third year.

3. The Investors Intelligence Bull/Bear Ratio (BBR) is a contrarian indicator, meaning:
   a) It'll only confuse you, so best to ignore it
   b) You should believe exactly what the BBR indicates
   c) Historically, it's paid off to be bullish if the BBR is extremely bearish and vice versa
   d) You should only heed the BBR if it indicates a bull market. If it indicates a bear market, pay no attention.

4. Diversification means investing in different companies, industries, sectors and countries. Investing in only one sector, or using only one method of selection, increases your risk:
   a) True   b) False

Email answers to: **stanclarkfinancialteam@cibc.ca** or call (604) 641-4361

One prize winner will be chosen by a draw from all those who submit correct answers. The draw will take place on May 31, 2024.

Trivia challenge runs April 1 - May 30, 2024. No purchase necessary. There is one prize to be won. Simply complete the trivia questions correctly to be entered in the draw. Limit 1 entry per person.

Chances of winning depend on number of eligible entries and whether you correctly answer the trivia questions. Open to adult Canadian residents (excluding Quebec). For full challenge rules, write to: The Stan Clark Financial Team, CIBC Wood Gundy 400-1285 West Pender St, Vancouver, BC V6E 4B1.

CIBC WOOD GUNDY | The Stan Clark Financial Team
Where planning, investing and behavioral finance meet

Phone: 604 641-4361 | Toll-free: 1 800 661-9442 | Fax: 604 608-5211 | Email: stanclarkfinancialteam@cibc.ca | www.stanclark.ca